



America was founded on notions of borders and taxes. Fortunately, the methods for resolving disputes over tax jurisdiction have become more civil than they were two hundred years ago, when armies and navies were called upon. On the other hand, the manpower devoted to devising, sorting through, and enforcing tax laws today is greater than that arrayed in our war against King George.

The Revolutionary War was fought to establish that only an elected government representing the American people may levy taxes on what transpires within our borders, but once commerce started transcending borders and businesses started operating in multiple jurisdictions, that quaint tax concept broke down. Determining *who* and *what* are taxable *where* would be complex enough if multistate and international business activities posed all-or-nothing questions. For example, a person who lives in

California and works in Nevada would be faced with paying income taxes in one state or the other, so the only question would be: Which state? Unfortunately, these types of decisions are not that simple.

Multinational corporations are certainly not new, but they are operating in new ways that exacerbate already complex tax determinations. For example, just-in-time processing has inspired many businesses to source components close-by. But, when a component is a new software application to be released with a soon-to-be-shipped laser printer, a Silicon Valley manufacturer can source it from one of its subsidiaries in Indian Springs, Indianapolis, or India – or in part from all three. So, for one print driver, California, Indiana, US, and Indian tax laws must be consulted, cross-referenced, and reconciled.

Laws, regulations, and court decisions are in place to help accountants and lawyers sort through overlapping claims of tax jurisdiction made by multiple states. When an international tax conflict arises, help can be provided by tax treaties the US has negotiated with many foreign countries. Yet, tax rules have trouble keeping up. Activities that were once small – such as international mail order sales and interstate provision of services – are growing, so what had been minor concerns about such activities escaping income, sales, use, and value added taxes (VAT) are now becoming major concerns about major sources of revenue.

***Technology and new management models for sourcing, manufacturing, and distribution are making it tougher to apply existing property, consumption, and income tax laws.***

Technology and new management models for sourcing, manufacturing, and distribution are making it tougher to apply existing property, consumption, and income tax laws. The same technology and management models are also making it easier for businesses to desert states and countries that take excessive or heavy-handed approaches when crafting new tax regimes or applying old ones. So, as governments try to develop approaches that will resolve the growing complexities, they need to enact tax laws that not only make sense, but that also make sense to businesses and the people who invest in them and work for them.

In particular, the tax challenges posed by Internet-based commerce should not inspire tax agencies to get out shoe horns to fit new business models into old frameworks. Nor should each state look for independent solutions based on Internet-specific tax regimes, as some have tried. Top-down federal preemption is not the right approach, either. Rather, we need a national policy implemented at all levels of government.

### **Sales Taxes, "Use Taxes," and "Nexus" A Primer**

Most people are familiar with sales taxes, the charge that is added to the cost of goods and some services purchased in retail stores. Sales taxes are imposed on sales transactions that occur within the boundaries of the taxing jurisdiction. Sales taxes are collected from the purchaser by the seller at the time of sale, and then remitted by the seller to the government(s) imposing them. In about two-thirds of the states that levy sales taxes, the tax rate that applies to a given purchase may be the sum of a statewide rate and one or more local government rates. Throughout the country, sales taxes typically amount to five to eight percent of the purchase price.

Use taxes are less familiar. All states (and many local governments) imposing sales taxes also impose "use taxes." Use taxes are charged on the purchase price of goods purchased out-of-state but brought into the state for consumption. The purpose of use taxes is to remove the incentive to purchase goods out-of-state where they might be taxed at a lower rate or not at all. If use taxes were not imposed and some consumers did have opportunities to buy out-of-state on a no-tax or lower-tax basis, state and local governments imposing sales taxes would lose revenues. In addition, merchants required to charge sales taxes would lose business—to the detriment of the local economy and employment.

The order form of mail-order catalogs is one place use taxes can be noticed. Many include a sentence like the following: "Residents of California, New York, and Illinois, please add applicable sales taxes." If, as an example, this mail-order company is located in California, the company is probably charging its New York and Illinois customers their states' "use tax" and its California customers the California sales tax. The seller will remit these taxes to the respective governments of the states in which these customers are located. Why is the seller collecting and remitting the New York and Illinois use taxes when it is based in California? Because the mail-order company has established what tax lawyers term "nexus" with those states. "Establishing nexus" means that the California-based seller has made sufficient contact, not only with California, but also with New York and Illinois, for those states to have legal power to require the company to collect and remit their respective sales and use taxes.

What is "sufficient contact?" U.S. Supreme Court decisions in the 1940s and 1950s clearly established that if a company had a physical presence in a state, such as a retail store, warehouse, or regular presence of traveling salespeople, the company could be required to collect from customers and remit the applicable use taxes. However, in its 1967 decision in *National Bellas Hess vs. Illinois*, the U.S. Supreme Court ruled that a mail-order company could not be required to collect and remit a state's use tax if the company's only activity in that state consisted of sending in by U.S. mail or common carrier (like UPS or Federal Express) its catalogs and the goods sold to in-state purchasers. This decision was reaffirmed by the Court in *Quill Corp. vs. North Dakota* (1992).

Even when a seller is not required to collect and remit use taxes, purchasers remain legally obligated to pay use taxes directly to their state and local governments. Although this remittance obligation is typically unknown or ignored by individual consumers, many businesses that make out-of-state purchases on which use tax has not been collected are aware of their obligation and do remit the use tax themselves.

From "A Federal 'Moratorium' on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households", by Michael Mazerov and Iris J. Lav, Center on Budget and Policy Priorities, May 11, 1998, <http://www.cbpp.org/512webtax.htm>

Internet-based electronic commerce is a product of great technology being used in clever ways to meet consumers' needs. This technology and the market changes it is making possible invite state, local, and national governments to harmonize and rationalize their tax rules, streamline procedures, reduce compliance costs for businesses, and eliminate discrimination.

In both the private and public sectors, old ways of doing things can and should be put aside – but basic principles remain. In commerce, the basic principle is serving the customer.

In tax policy, there are also basic principles –

- **Neutrality:** This is the tested notion that even-handed taxation yields the best economic results for the public. Tax policy should generally not seek to favor or specially burden any one commercial activity – it should not discriminate.<sup>1</sup> An example of a discriminatory tax is the three percent federal excise tax on telephone calls which does not apply to any other telecommunications service and the revenues from which fund general government programs. Even if that tax was levied on all telecommunications services, it would be discriminatory against telecommunications. On the other hand, there are some instances in which an otherwise discriminatory tax contains features which ameliorate its discriminatory affects. For example, the federal excise tax on gasoline: Gas tax revenues are earmarked for the federal Highway Trust Fund which was designed, in principle, to benefit those paying the tax.<sup>2</sup>

- **Lowest rates on the broadest base:** In some states, clothing is exempt from the sales tax because it is deemed a necessity. Yet, that decision inherently requires the overall sales tax rate to be higher – including on building materials which a consumer buys at a home-center store to construct an extra bedroom on his house, which for him may be a necessity as his family grows. Additionally, while a broad tax base *allows* taxes to be lower, it is still incumbent upon elected officials to *ensure* that the overall tax burden is as low as possible – consistent with funding only necessary functions of government.

- **Transparency:** Tax laws should be clearly articulated so that taxpayers can know in advance what taxes will be due on a particular economic activity.

***It may be surprising to some that this private-sector Council supports a workable system for collecting and remitting taxes for on-line sales. We do. What we vehemently oppose is a hodge-podge of a system that looks only at the Internet and is therefore manifestly unfair, or that is needlessly complex and uncertain in its application and is therefore unfathomably expensive.***

- **Ease of implementation:** It is important to taxpayers that compliance with tax rules be as easy and inexpensive as possible; these attributes are also important to government, because a streamlined system can cost the government less to administer while encouraging taxpayer compliance.

The fact that the Internet is inherently borderless and government is defined by its borders does not change these principles, but for them to retain their effectiveness, current tax laws must be upgraded. The focus must shift from expansive legislation and aggressive enforcement to rationalization and harmonization among the governments whose borders contain the sellers, buyers, and all the shifting points in between.

### "INTERNET TAX FREEDOM ACT"

The aim of the Internet Tax Freedom Act is neutral tax treatment of economic activity, electronic or otherwise. Toward this end, the bill precludes state and local taxes that discriminate against or single out the Internet. Highlights of the Internet Tax Freedom Act:

**Tax-Free Internet Access.** Prohibits state and local governments from imposing taxes on Internet access charges--the \$19.95 or so that millions of Americans pay to our nation's 4,000 Internet service providers (including both "pipeline" services like Erol's and value-added online services like America Online or Compuserve).

**No discriminatory treatment of the Internet.** Protects against the imposition of new tax liability for consumers and vendors involved in commercial transactions over the Internet. This includes the application of discriminatory tax collection requirements imposed on out-of-state businesses through strained interpretations of 'nexus.'

**Study and Report to Congress.** Creates a temporary commission to study taxation of Internet commerce, and report back to Congress in [three] years on whether the Internet ought to be taxed and, if so, how taxes can be applied without subjecting Internet and electronic commerce to special, discriminatory, or multiple taxation.

**Promotes Global Free Trade on the Internet.** Calls on the Administration to demand that foreign governments keep the Internet free of taxes and tariffs.

Source: Internet Tax Freedom Act Homepage  
Operated by US Representative Christopher Cox  
Sponsor of the Cox/Wyden bill, H.R. 4105/S. 442<sup>3</sup>  
<http://www.house.gov/cox/nettax/Web-FAQ.html>

Selling over the Internet is a different way of doing business, yet the underlying e-commerce transaction – the retail sale – should not be exempt from taxation. After all, state and local governments do need to raise revenues for essential operations, and consumption taxes – such as sales taxes – are an entirely legitimate type of tax to levy. Unlike many types of taxes, sales taxes are readily apparent to the consumers who are paying them and they provide diversity in the mix of revenue sources for government. Yet, if sales taxes are to remain an available method for funding government – and if tax rates are to be set at as low a rate as possible – the tax base must be broad. That weighs in favor of taxing on-line sales of tangible goods – but the analysis is not yet complete.

Those constructing a new sales tax system should not discriminate for or against certain channels of commerce – whether over the counter at a local store, over the Internet, over the telephone, on the TV, or in one's mail box. The public policy goal is not to protect the very existence of stores on mainstreet; certainly, e-commerce will put out of business a variety of bricks-and-mortar stores, just as supermarkets put many butchers and bakers out of business. Rather, the goal is neutrality.

The problem today is that if states (and local governments) were to immediately begin taxing on-line sales, current definitional and enforcement policy differences among the states would impose enormous compliance costs on e-commerce businesses as they struggled to understand requirements and sort through state-to-state conflicts. The rules would appear neutral on their

face – telling both Internet and over-the-counter sellers to collect taxes on the sale of all tangible goods – but the rules would actually disadvantage digital stores severely because for them the costs of compliance would be punishing. Neutrality does not merely mean that one state's buyers be required to pay the same tax rate at all stores; neutrality also entails comparable compliance costs for these stores. The arguments put forth here do not justify maintaining the *status quo*, but they do support an effort to create a sales tax system that is neutral in the overall burden that it places on buyers and *all* sellers.

***If those constructing a new sales tax system truly want to embrace the neutrality principle, they must not discriminate for or against certain channels of commerce whether over the counter at a local store, over the Internet, over the telephone, on the TV, or in one's mail box.***

A rational, neutral solution can be crafted, but it must wait for two policy milestones to be reached. First, a consensus must be achieved that e-commerce – this different way of doing business – should not be taxed *in and of itself*. No special Internet access taxes; no creative attempts to cram new on-line services into old tax definitions. In other words, visiting a mall should not be taxed, even if the purchases made there are. Otherwise, government will be acting simply as a toll collector reacting to the sight of an opportunity to collect

money promiscuously. A toll is justifiable when it supports the efficient maintenance of a road or bridge; here, after general tax revenues have fully paid for the initial development of the Internet by the federal government, discriminatory state and local taxes on the Internet have no justification.<sup>4</sup>

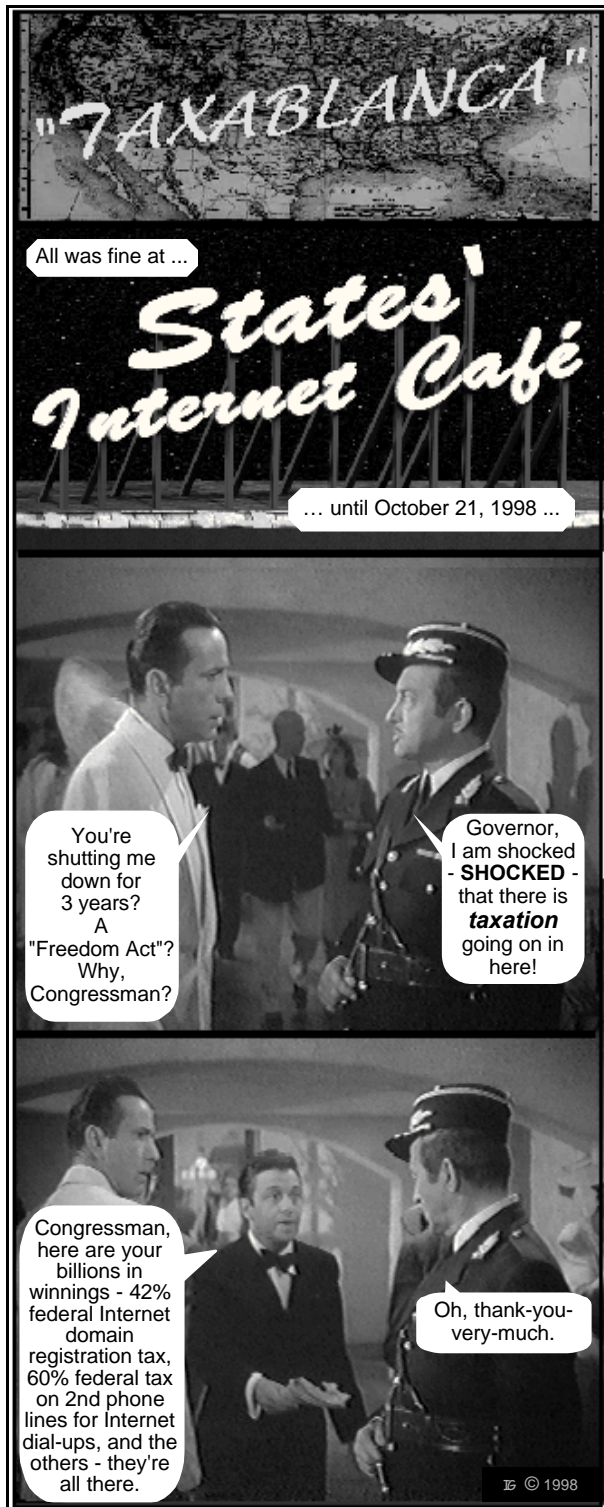
Second, a national approach to sales and use tax collection must be devised for all interstate sales – including "mail-order" sales. It must be easily understood by buyers and sellers, ensure that sales are only taxed once, make clear what goods are taxed and at what rate, and be designed from the start to be reliable and low-cost for all taxpayers.

Since achieving this rational tax system will entail forging a consensus among fifty states that have long histories of taking divergent approaches to taxing commercial activities, reaching the goal will take some time. That is why the Council was pleased that Congress recently passed the Internet Tax Freedom Act (ITFA) – legislation that places a three-year moratorium on the imposition of discriminatory taxes on Internet-related activities.<sup>5</sup> This "time-out" will provide an opportunity for careful consideration of alternatives by all "stakeholders," discussions among state officials, and a review of a sales tax proposal that will be made by the study commission created by the ITFA<sup>6</sup>, to be submitted to Congress prior to April 2000.

The companies represented on the Council have their economic futures riding on the success of e-commerce. Therefore, it may be surprising to some that this private-sector Council supports a workable system for collecting and remitting taxes for on-line sales, as described. We do. What we vehemently oppose is a hodge-podge of a system that looks only at the Internet and is therefore manifestly unfair, or that is needlessly complex and uncertain in its application and is therefore unfathomably expensive. That is what we would have without a sustained period of sober consideration, which was initiated by the introduction of the federal Internet Tax Freedom Act and which is arguably ensured by the bill's enactment. The ITFA provides the time and the focus of purpose that can yield an effective and workable system meeting the principles of tax neutrality, broad application, low rates, transparency, and low-cost administration.

***A consensus must be achieved that e-commerce itself this different way of doing business should not be taxed. No special Internet access taxes; no creative attempts to cram new on-line services into old tax definitions.***

It is worth noting that business leaders elsewhere in the world share our view. In a report presented to the OECD last year, the "Sacher Group" stated, "The main concern of the Group is not that electronic transactions will be subject to tax, but that the tax regime employed is workable and non-discriminatory."<sup>7</sup>



While the ITFA's moratorium on discriminatory state and local taxes is welcome, the mere "sense of Congress" provision in the legislation that no new federal taxes *should* be levied on the Internet is not what it *should be*<sup>8</sup> – it erects no substantive roadblocks. Indeed, the ITFA conspicuously overlooks a federal Internet tax retroactively sanctioned by Congress earlier this year that imposed a 42 percent tax on Internet domain registration fees.<sup>9</sup> Additionally, the ITFA-created study commission – charged with recommending tax policies to engender development of the Internet – is specifically prohibited by the ITFA from reviewing the billions of dollars in taxes levied on telecommunications under the authority of the 1996 Telecommunications Act and other, decades-old rules.<sup>10</sup> Therefore, the new federal Advisory Commission on Electronic Commerce is blocked from recommending repeal of discriminatory communications taxes that add more than 60 percent to the price a Californian pays for a second telephone line used for Internet access.<sup>11</sup>

While the ITFA will stop tax discrimination nationwide, within California it will serve as add-on suspenders for the belt already cinched around the possibility of new state and local taxes being targeted at the Internet – since the Legislature passed and on August 24 the Governor signed the California Internet Tax Freedom Act.<sup>12</sup>

Pre-emptive strikes for a sound tax approach to e-commerce were also made last year by the California Board of Equalization (BOE). First, the Board announced its support for the ITFA – which was unusual in that the BOE is the state agency responsible for collecting sales taxes; normally agencies do not endorse bills that impose limits on their authority. More significant than its support for the ITFA, the BOE made a critical decision to not assert sales tax jurisdiction based solely on a seller using a California-based server for e-commerce transactions.<sup>13</sup> If the BOE's policy was otherwise – if it adopted a policy holding such transactions taxable – many sellers would have simply switched to servers located

outside of the State. The fiscal result could well have been a net loss, since the State might have secured no additional sales tax income yet would have lost jobs associated with installing, operating, and maintaining the servers – and the tax revenues tied to those jobs.<sup>14</sup>

In sum, efforts made within California, along with more recent ones in Washington, D.C., have established an environment for careful crafting of good, principled tax laws that will affect e-commerce and other distance-selling transactions. Therefore, the Council's recommendations primarily focus on the post-Internet-Tax-Freedom-Act world: What should the tax regime look like when the ITFA's three-year moratorium ends?

### **RECOMMENDATIONS**

- **1 The Council recommends** that – when considering the application of existing and proposed tax laws to electronic commerce – governments at the local, state, and national levels should abide by basic tax principles: Neutrality, the lowest rates on the broadest base, transparency, and ease of implementation for taxpayers.<sup>15</sup>
- **2 We recommend** that actions be taken at the state and national levels to rationalize and harmonize rules for income, property, and consumption taxes to reduce (i) government and private sector compliance costs, and (ii) the likelihood that economic activities will be taxed more than once.<sup>16</sup> This effort will help produce clarity, certainty, and neutrality, which in turn will promote the expansion of e-commerce. The goal is neither federal preemption nor, necessarily, a comprehensively unified system administered by the states independently – though the latter would provide numerous benefits, even if it is currently unachievable in our federal system. Rather, tax law writers and tax administrators in the fifty states should understand what others are doing in order to reduce, as much as possible, overlapping taxes and conflicting requirements. For example, if an agreement can be reached among the states that sales tax jurisdiction will not be asserted merely on the basis of where a server is located – the position taken by the California Board of Equalization – then there will be one less basis on which two states might try to tax one transaction twice.
- **3 We recommend** that, through the efforts of the Advisory Commission on Electronic Commerce that has been created by the Internet Tax Freedom Act,<sup>17</sup> and with eventual federal enabling legislation,<sup>18</sup> a multi-state agreement be devised authorizing states to which purchased tangible goods<sup>19</sup> are shipped to require out-of-state companies to collect and remit sales taxes. The agreement should include, among other elements, the following –
  - A low-cost system for implementation – such as a unified set of definitions for determining which goods are taxable, and a single point of tax reporting and remittance in each state for retailers.
  - A low-cost system for compliance – such as requiring that any audit that is performed be done at the state level (that is, explicitly not at the county or tax district level), accommodating the possibility of consolidated multi-state tax audits, and providing a safe-harbor rule for good faith compliance in the collection of sales taxes that only permits prospective remedies that carry no penalties.<sup>20</sup>
  - An agreement that authoritatively establishes that sales taxes will be collected by the merchant on behalf of the "destination" state to which the goods are shipped.<sup>21</sup>
  - A rule that prohibits a state from requiring out-of-state sales tax collection and remittance if it does not first implement the changes contained in such agreement. In other words, after a plan is developed by the federal Advisory Commission on Electronic Commerce and it is blessed by Congress in the form of a law that authorizes sales tax collections on interstate sales, each state will have to make conforming changes to its laws. For example, any state that currently requires sales tax receipts to be remitted to local tax jurisdictions will have to devise a single point of remittance for out-of-state sellers. Until that change is made, that state would not be allowed to require out-of-state sellers to collect and remit sales taxes.

- A comprehensive approach that applies to all interstate sales and shipments of tangible goods – including mail order sales, telephone sales, and cable TV "home shopping" sales. Unless all forms of interstate sales of tangibles are covered, the principle of tax neutrality will not be served for tangibles.

- **4 We recommend** that the *status quo* be maintained for taxing the interstate sale of intangibles and provision of services. In other words, the federal legislation that we support, authorizing states to require sales tax collections by out-of-state sellers, would apply only to the sale of tangible products.<sup>22</sup>

Effectively collecting taxes on intangibles and services would be inherently difficult for even the most conscientious merchant. After all, to paraphrase a famous Internet aphorism: On the Internet, no one knows you're a German Shepherd, a Chinese Shar-pei, or the mutt next-door.

In other words, while an e-commerce sale of tangible goods entails shipment of the goods to the buyer, thereby establishing a basis for ascertaining a "'situs" for sales tax purposes, there is no such "bright line test" for electronic delivery. Even California tax officials find the challenge problematic.<sup>23</sup>

A workable system for intangibles would require merchants to collect the buyer's billing address, for which the merchant has no business need if the product is being delivered electronically.<sup>24</sup> Even if the merchant obtains the buyer's billing address – which would be rebuttably presumed to be the ship-to address – a buyer in a state that taxes e-delivery of software could buy it as a "gift" for someone in a state that does not levy such a tax. Under our proposal for taxing the sale of tangible goods, the merchant would collect sales taxes for the state to which goods are shipped – the approach proposed by most commentators. Therefore, the buyer's state would not capture the transaction when the sale is structured as

### The Lopez Family Working and Shopping in the Internet Age

Rick and Maria Lopez, with their children Jesus and Ida, live in a northeast suburb of Sacramento. Rick is an attorney at a law firm in the city, while Maria is an architect at Johnson Homes, a developer in Reno, Nevada. For four years, Maria has been driving three to four hours every day to and from her job, but she has told her boss that she is about to start looking for a job closer to home. In an effort to keep a good employee, Maria's boss suggests that Maria telecommute from home 10 days each month. She accepts.

Johnson Homes gives Maria a generous budget to outfit a home office, complete with high-speed ISDN Internet service. At work, Maria uses the Internet to find just the right desk. Using her company credit card, she buys it on-line from an Illinois furniture retailer, which arranges to have it delivered directly to her home from a manufacturer in Oakland. Maria calls the Reno electronics firm that her company uses and arranges for them to deliver and install in her home her computer, that had recently been installed at Johnson Homes. She asks Rick to pick up pencils and other supplies at a stationery store in Sacramento – though he has to stop back at the store the following week to pick up a lamp that the store must custom-order from a company in Pennsylvania.

The Lopez kids love the ISDN service Mom has arranged, and they now are the envy of their friends who stop by to enjoy the 128 bits-per-second connection. Yet, it is not too long before Jesus and Ida convince Mom and Dad that it is time to upgrade the kids' computer to one that is "worthy" of a high-speed Internet connection – which Maria purchases by phone from a small build-to-order company in New Hampshire.

The kids get \$50 each for new software. Ida spends her money to buy a new game from a Los Angeles company called X-Off. After using Dad's credit card to buy the game from the X-Off website, Ida downloads it from a computer "server farm" in Oregon run by a San Francisco company X-Off has contracted with to handle distribution. Jesus uses the same credit card to buy a mini-CAD program from the CompUSA website, and the shrink-wrapped software is shipped from a warehouse in Arizona.

Six months later, Maria and Rick discover that they are expecting a third child, so Maria decides to leave her job. Yet, she would still like to work part-time. Johnson Homes agrees to an arrangement whereby Maria helps with overflow projects, working entirely out of her home – occasionally video conferencing with the home office in Reno.

All is well for the next 18 months. Then, as California tax authorities are wrapping up an audit of Johnson Homes, based on a subsidiary the company had formed for a Fresno housing development they completed in 1993, the company is asked whether they still have any employees in California. They mention that they employ an architect who telecommutes from Sacramento.

There are a number of tax issues faced by the Lopez family and Johnson Homes. A few are highlighted below.

The Lopez Family  
Paying Taxes in the Internet Age

Here are a some of the tax issues faced by the Lopez family and Maria Lopez' employer, Johnson Homes:

Income taxes – California taxes Californians on all income, even if earned out of state. So, all of Maria Lopez' salary from Johnson Homes is taxable, even when she is working full-time in Nevada. California would allow Maria Lopez a credit for income taxes paid in Nevada, but Nevada does not impose an income tax.

Sales taxes – They are owed on Maria Lopez' purchase of furniture even if the Illinois retailer has no "nexus" (e.g., in the form of a subsidiary) in California. That liability arises because the goods were shipped within California – and when a California company drop-ships goods, it is considered a retailer for sales tax purposes. Whether or not the tax is collected from Maria Lopez by the Illinois retailer, the manufacturer/ drop-ship-retailer is liable for it.

Use taxes – They are owed on the recently purchased computer equipment transferred from the Johnson Homes office in Reno to the Lopez' home, but a credit may be available if sales taxes were been paid to Nevada. The software Iida downloaded is not subject to sales tax, regardless of where the server farm is located. Even though the CompUSA webserver and its warehouse are located outside of California, CompUSA collects sales tax from Jesus for his purchase, and sends it to Sacramento, because the company has retail stores in the State.

The computer shipped in from New Hampshire – that state has no sales tax, and in any event that kind of sale usually escapes taxation because, under longstanding US Supreme Court decisions, California cannot force the out-of-state company to collect sales/use taxes on California's behalf. While Californians technically owe use taxes – equivalent to the sales tax – on out-of-state purchases shipped into the State, the liability is little known and difficult, at best, for consumers to meet.<sup>25</sup> Then there is the question as to whether Johnson Homes has to pay income taxes in California because it has an employee working in Sacramento.

None of these issues is entirely new, but e-commerce and Internet-enabled telecommuting – both of which have no technological concern about borders – are making the issues more important. This is true because many of the taxable events mentioned above have historically "leaked" through the system, escaping proper taxation. Since they have been relatively small in the aggregate, the harm has been commensurately small. That arguably is not, and soon will certainly not be, true any longer.

a gift. After the goods were delivered by the merchant, the recipient would forward it on to the buyer; even if this circumvention is outlawed, it is doubtful that any affordable and practical system could be created to catch the outlaws. While current bandwidth limitations would discourage this triangular delivery system, that problem will not last long.<sup>26</sup>

Two aspects of our proposal that should be noted: First, our proposal would not prevent states from collecting use taxes *directly* from their residents who buy and take delivery of intangibles and services over the Internet – just as some states, today, have mechanisms in place to directly collect use taxes on tangible and intangible goods shipped to their residents, especially when the buyers are businesses.

Second, since e-delivered products and services are not taxable in California, our proposal – which would not permit states to require out-of-state sellers to collect and remit the tax – would not affect California's sales tax revenues. Nevertheless, even for those states which would like out-of-state sellers to collect taxes on intangibles and services, we suggest that a cost-benefit analysis would not justify the effort necessary to achieve an acceptable level of compliance. As we stated in the report's introduction:

"Unarguably for the present, probably to the horizon, and perhaps for all time, aggressive attempts by government to restrict what happens on the Internet will be only marginally effective when confronted by a combination of technology, borders, and consumers' choices."

While this text explicitly refers to government attempts to restrict Internet activities, the inherent difficulties are the same when attempting to impose consumption taxes on transactions in which the sale and delivery both transpire on-line.

Since we have argued throughout this report in favor of public policy neutrality – no discrimination for or against the Internet – we are emphatically not arguing here that a tax exemption should be created for intangibles and services simply because they are Internet-based. We are not saying that this form of e-commerce should receive special treatment. Indeed, in a world in which the administrative overhead for tax calculations,

remittance, filing, and compliance were *de minimis* even for Draconian rules, on-line sales and delivery of services could be taxed practically and effectively, and under the neutrality principle arguably they should be taxed. However, only overly burdensome rules could be broadly effective in taxing e-delivered products – that is, subject to only minimal leakage – yet such rules would be overly costly, and that should make them untenable. Therefore, actual neutrality between the new digital world and the existing analog world cannot be achieved for intangibles. The same is probably true with regard to services. In the end, states will have to make their own calculations – looking at both the potential for new revenues as well as the potential for chasing Internet-based businesses to the border and beyond. If they can propose a system that can be broadly effective while meeting the "ease of implementation" principle, then Congress should consider allowing states to require out-of-state sellers to collect sales taxes on intangibles and services. We believe that such a system does not exist and is not on the horizon.

- **5 We recommend** that the California Board of Equalization consider, on an ongoing basis, whether sales and electronic delivery of software, music, books, magazines, and other such goods (which are non-taxable under current law) have become so significant that sales of such products in tangible form should also be made nontaxable. For example, if software delivered electronically captures more than 35 percent of the market, the principle of tax neutrality – as well as equity for consumers and among sellers – would support elimination of sales taxes on so-called "shrink wrapped" software that is delivered in a physical medium, such as a CD-ROM.<sup>27</sup>

The Board of Equalization should report to the Governor and the Legislature its findings about the on-line distribution channel as it develops, recommending tax reductions as appropriate to achieve comparable tax treatment between the digital and physical markets.

- **6 We recommend** that, once a new system for taxation of interstate sales is in place, California and each other state that levies a sales tax should review the tax-base-broadening revenue impact of the new system and consider reducing its sales tax rate. For example, states could lower the rate such that there is no net increase in aggregate sales tax revenues.<sup>28</sup> While the Council is not recommending that a state adopt any particular rate, we do draw attention to the tax principles at issue, specifically that the best tax policy embodies a broad base and low rates. Since a law allowing a state to collect sales taxes on interstate sales helps that state meet the base-broadening goal, the state should also strive for the second goal – lower rates.

*Combined State and Local General Sales Taxes as a Percentage Share of State's Total State/Local Taxes  
(Fiscal Year 1995 Source: Census Bureau)*

|                |      |                   |      |               |      |                   |             |
|----------------|------|-------------------|------|---------------|------|-------------------|-------------|
| Tennessee      | 46.1 | New Mexico        | 41.8 | Louisiana     | 40.5 | Nevada            | 38.5        |
| Hawaii         | 37.6 | Washington        | 36.5 | Arizona       | 35.7 | Arkansas          | 35.5        |
| Mississippi    | 35.3 | Florida           | 34.5 | South Dakota  | 33.6 | Texas             | 32.3        |
| Utah           | 32.2 | Alabama           | 30.9 | Georgia       | 30.4 | Oklahoma          | 30.1        |
| Missouri       | 28.8 | Colorado          | 27.9 | Kansas        | 27.1 | <b>California</b> | <b>26.8</b> |
| South Carolina | 26.1 | Michigan          | 25.0 | Wyoming       | 24.2 | Idaho             | 24.0        |
| Nebraska       | 23.4 | North Dakota      | 22.4 | West Virginia | 22.2 | Iowa              | 21.7        |
| Maine          | 21.2 | Indiana           | 21.2 | Ohio          | 20.9 | Kentucky          | 20.7        |
| Minnesota      | 20.0 | Dist. of Columbia | 19.9 | Connecticut   | 19.6 | Illinois          | 19.5        |
| Pennsylvania   | 18.9 | Wisconsin         | 18.7 | New York      | 18.0 | Rhode Island      | 17.3        |
| Virginia       | 16.4 | New Jersey        | 15.8 | Maryland      | 14.0 | Massachusetts     | 13.7        |
| Vermont        | 12.0 | Alaska            | 4.0  | Delaware      | 0    | Montana           | 0           |
| New Hampshire  | 0    | Oregon            | 0    |               |      |                   |             |

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<sup>1</sup> A theoretically completely neutral tax would tax all transactions only once and at the same rate. In the real world, however, issues of administration and compliance, and perhaps other issues as well, make it impossible to achieve complete neutrality. Some balancing of the need to minimize administrative and compliance costs with deviations from the neutrality principle must be made.

<sup>2</sup> Taxes paid into the Highway Trust Fund can generally be considered as user fees because Fund receipts are used "in principle" to benefit those paying into the fund. We emphasize the "in principle" concept because, in fact, Trust Fund monies have been diverted to other programs from time to time. So, one must be wary when asked to support a "user fee" which is "designed" to benefit those paying the fee, because administrators of the program may not show fealty to its initial design. Additionally, even a true "user fee" is objectionable if the revenues are spent on programs which cannot be justified by a rigorous cost-benefit analysis – irrespective of the fact that all of the revenues are passed through to benefit the payors. An example would be a new eight-lane highway, built with gas tax revenues, when only a four-lane highway is needed.

<sup>3</sup> The "Internet Tax Freedom Act" was enacted on October 21, 1998, as of Division C, Title XI, of H.R. 4328, the "Omnibus Consolidated Appropriations Act", Public Law 105-277, hereinafter referred to as "Omnibus Act".

<sup>4</sup> At a time when the Internet was being supported by federal funds, a fee earmarked for those internet improvements and maintenance that met sound cost-benefit standards would have been justifiable as a "user fee." Today, the same fee would constitute a tax unless it could be shown to finance improvements and maintenance that both would not be made by the private sector and passed rigorous cost-benefit criteria.

<sup>5</sup> In order to clear the way for passage of the ITFA by Congress, it was necessary for congressional sponsors of the legislation to reach some accommodation with the National Governor's Association – which vehemently opposed it at first. That accommodation was possible because Governor Wilson and Governor Gilmore of Virginia waged an ultimately successful battle against the tide within the NGA in order to promote compromise. The turn-around was so significant within NGA that, upon passage of the Internet Tax Freedom Act by the US Senate, the NGA issued a press release headlined, "Governors Hail Senate Passage of Internet Bill". <http://www.nga.org/Releases/PR-08October1998Internet.htm>

<sup>6</sup> Omnibus Act, Section 1102(g)(3) reads:

"SEC. 102. ADVISORY COMMISSION ON ELECTRONIC COMMERCE.

"(a) Establishment of Commission: There is established a commission to be known as the Advisory Commission on Electronic Commerce (in this title referred to as the 'Commission'). The Commission shall--

"(1) be composed of 19 members appointed in accordance with subsection (b), including the chairperson who shall be selected by the members of the Commission from among themselves; and

"(2) conduct its business in accordance with the provisions of this title.

"(b) Membership:

"(1) In general: The Commissioners shall serve for the life of the Commission. The membership of the Commission shall be as follows:

"(A) 3 representatives from the Federal Government, comprised of the Secretary of Commerce, the Secretary of the Treasury, and the United States Trade Representative (or their respective delegates).

"(B) 8 representatives from State and local governments (one such representative shall be from a State or local government that does not impose a sales tax and one representative shall be from a State that does not impose an income tax).

"(C) 8 representatives of the electronic commerce industry (including small business), telecommunications carriers, local retail businesses, and consumer groups, comprised of--

"(i) 5 individuals appointed by the Majority Leader of the Senate;

"(ii) 3 individuals appointed by the Minority Leader of the Senate;

"(iii) 5 individuals appointed by the Speaker of the House of Representatives; and

"(iv) 3 individuals appointed by the Minority Leader of the House of Representatives."

<sup>7</sup> "Electronic Commerce: Opportunities and Challenges for Government" (The "Sacher Report") June 12, 1997, presented to the Organization for Economic Co-operation and Development, <http://www.oecd.org/dsti/sti/it/ec/act/sacher.htm>

<sup>8</sup> Omnibus Act, Section 1201 reads:

"TITLE II--OTHER PROVISIONS

"SEC. 201. DECLARATION THAT INTERNET SHOULD BE FREE OF NEW FEDERAL TAXES. It is the sense of Congress that no new Federal taxes similar to the taxes described in section 101(a) should be enacted with respect to the Internet and Internet access during the moratorium provided in such section."

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<sup>9</sup> While the tax is not currently being collected due to pending federal litigation, Congress granted authority to the National Science Foundation to impose it – more than a year after the NSF had started collecting it without congressional approval. See the 1998 Emergency Supplemental Appropriations Act, Public Law No: 105-174, enacted May 1, 1998 (H.R. 3579). These comments should not be interpreted as critical of the Internet-related research intended to be supported by the 42.8 percent tax; rather, we question whether this research should be funded from general federal revenues.

<sup>10</sup> Omnibus Act, Section 102(g)(3) reads:

“(3) Effect on the communications act of 1934: Nothing in this section shall include an examination of any fees or charges imposed by the Federal Communications Commission or States related to—

“(A) obligations under the Communications Act of 1934 (47 U.S.C. 151 et seq.); or

“(B) the implementation of the Telecommunications Act of 1996 (or of amendments made by that Act). “

<sup>11</sup> In California, if a consumer installs a second telephone line for Internet access, he pays approximately \$7 each month in special taxes and fees – which constitute a 62% tax on standard flat-rate telephone service for which Pacific Bell charges \$11.25 per month.

<sup>12</sup> [http://www.leginfo.ca.gov/pub/bill/asm/ab\\_1601-1650/ab\\_1614\\_bill\\_980824\\_chaptered.html](http://www.leginfo.ca.gov/pub/bill/asm/ab_1601-1650/ab_1614_bill_980824_chaptered.html)

<sup>13</sup> On September 10, 1997, the Board of Equalization approved the addition of the following language to Regulation 1684, “Collection of Use Tax by Retailers”:

“The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California. No Internet Service Provider, On-line Service Provider, internetwork communication service providers, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.” 18 CCR 1684(a)

<sup>14</sup> See “Read My E-Mail: No New Taxes,” by Dean F. Andal, California State Board of Equalization, May 5, 1997. This paper was presented at the Symposium on Multijurisdictional Taxation of Electronic Commerce, sponsored by the International Tax Program and The Society for Law and Tax Policy, Harvard School of Law, Cambridge, MA, held on April 5, 1997. It was also reprinted in State Tax Notes Magazine, May 5, 1997 (1 State Tax Notes 1387) <http://www.e-commerce.ca.gov/backgroundmaterials/Andal-StateTaxesOnEComm.html>

<sup>15</sup> Neutrality should be the touchstone for all telecommunications taxes, as any discriminatory tax on telecommunications necessarily affects investments in and use of the Internet. The Internet is essentially a platform for telecommunications – a telecommunications service. While Congress has correctly established that the Internet should not be burdened by discriminatory taxes, traditional telephone service is subjected to billions of dollars in discriminatory taxes and “fees” to subsidize rural telephone subscribers and Internet connections in schools, as well as just to raise money for the federal government. While these subsidized are arguably worthwhile, they do not justify discriminatory taxes. See “Technology Will Kill Telecom Taxes”, *Wall Street Journal*, by Ira H. Goldman (August 10, 1998) [http://www.e-commerce.ca.gov/forum/defininggovtrole/2c\\_wsj\\_telecom.html](http://www.e-commerce.ca.gov/forum/defininggovtrole/2c_wsj_telecom.html); See the main text accompany notes 4-6.

These targeted taxes and fees also discourage Internet use: In California, if a consumer installs a second telephone line for Internet access, he pays approximately \$7 each month in special taxes and fees – which constitute a 62% tax on standard flat-rate telephone service for which Pacific Bell charges \$11.25 per month.

<sup>16</sup> By stating that no economic activity should be taxed “more than once”, we are also making reference to what some commentators call “nowhere taxes” – a transaction that arguably does not have a tax “situs”. General notions of tax policy argue that every transaction should have a tax situs in some jurisdiction – i.e., a place where it can be said that the transaction is “taxable” – even if that jurisdiction does not levy a particular tax. For example, under a new system for levying taxes on interstate sales, if a sale is properly assigned to New Hampshire, then no sales tax would be payable since New Hampshire does not levy a general sales tax. We are emphatically *not* suggesting that this situation should be otherwise or that any existing tax exemptions be repealed.

<sup>17</sup> See note 6, above.

<sup>18</sup> Decisions issued by the U.S. Supreme Court have made clear that a state does not have the authority, under the Constitution, to require an out-of-state seller to collect sales/use taxes on its behalf when goods are shipped into that state (and the seller has no “nexus” in that state). The Court has also indicated that Congress has the power to grant states that authority by enacting legislation. *National Bellas Hess v. Dept of Revenue of Ill.*, 386 U.S. 753 (1967); *Quill v. North Dakota*, 504 U.S. 298, 119 L.Ed.2d 91 (1992)

<sup>19</sup> For purposes of our report, items that are physically delivered should be subject to the new system we propose that allows states to require out-of-state sellers to collect and remit sales taxes on goods shipped into the state.

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Items that are delivered electronically should not be subject to this system. See Tax Recommendation 4. (On the other hand, as noted elsewhere in our report, a state should not be prohibited from requiring sellers to collect sales taxes on a sale *if* the seller has a tax nexus in the state.)

By drawing the line in this fashion, we generally avoid having to resolve the significant definitional differences among the states as to whether – for sales tax purposes – certain products are “tangible” or “intangible” or whether they constitute a service. These differences would otherwise add one more aspect of complexity as efforts are made to devise a new transparent and easy-to-implement sales tax system for interstate sales.

Some intangible/tangible/services examples:

(a) When a custom-made piece of personal property is constructed, some states combine the value of services performed with the value of parts used in the construction and impose sales tax on the entire amount, while other states tax only the value of the parts.

(b) In California, software delivered electronically is not subject to sales tax because the software, itself, is considered a service, and the state does not tax services; if the software is sold in physical form – such as on a CD-ROM – it is considered a good and therefore its sale is taxable.

(c) A number of other states, having considered the neutrality principle and other tax policy issues, impose sales taxes equally on e-delivered software and shrink-wrapped software.

<sup>20</sup> Some states require sellers to remit sales tax receipts to each local jurisdiction (e.g. counties) that levies a sales tax. Each jurisdiction may also conduct an independent audit to ensure the seller's compliance.

<sup>21</sup> Most discussions about a system for collecting sales taxes on interstate sales have supported the idea that jurisdiction lies with – and therefore money will flow to – the state of destination (where the goods are shipped) or the state where the bill is sent. An alternative approach, which has received some increased attention since e-commerce has reinvigorated the distance-sales tax debate, is that tax jurisdiction should be based on the seller's operations, not the buyer's. See "The Seller-State Option: Solving the Electronic Commerce Dilemma", by Terry Ryan (Apple Computer) and Eric Miethke (Nielsen, Merksamer, Parrinello, Mueller and Naylor, L.L.P.) 15 State Tax Notes 881, and "*Jefferson Lines* as the Ticket to Cyberspace? A Proposal for the Taxation of Electronic Commerce Services" by Arthur Angstreich, senior vice president for taxes with PolyGram Holding Inc. and adjunct professor at Fordham University, James R. Fisher, vice president and senior tax counsel for PolyGram Holding Inc., and Eric J. Miethke, 14 State Tax Notes 1993.

In both the origin and destination approaches, the arguments are based on certainty (i.e., the certainty of knowing where the goods are shipped *versus* relative to the certainty of where the seller does business), simplicity (i.e., how difficult is it for the seller to know on which state's behalf taxes should be collected), and appropriateness (which state "deserves" the tax revenue.) Additionally, the origin approach is presented as preferable because, it is claimed, it will be easier to implement when sales are made between the US and countries in the European Union, which impose a VAT (value added tax). (This latter argument appears to be predicated on consideration by the EU of changing its VAT from a destination approach to an origin approach; however, a plan to make that change has been delayed until January 1, 2002, and according to a paper presented to the OECD by the CEOs of IBM and NCR, that date is likely to slip further.

For tangibles, one always knows where the address to which the goods are shipped – which may or not be the same as the billing address, e.g. sales to businesses and gift purchases. While one does always know where the sales person is located, consider that the seller often is selling something that may be housed and shipped from one of many warehouses around the country (or in a foreign country). In that instance, a question arises as to whether the tax should be levied on behalf of the state where the seller was running his sales operations (which also could be in multiple call centers dispersed nationwide) or on behalf of the state where the warehouse is from which the goods are shipped? Sometimes, the sales transaction (including calculation of the bill) is completed before the seller knows from which warehouse the goods will be shipped – especially if it will be dropped shipped.

Then there is the situation where there is no sales person – when a sale is conducted entirely electronically. In this case, would the location of the Internet server (the computer that handles the transaction) be considered the place where the seller is doing business? The California Board of Equalization (the State's sales tax agency) has explicitly decided that it will not assert jurisdiction on the basis of where a transaction server is located, and this initiative has been lauded by industry.

In the case of intangibles delivered electronically via the Internet, where there is no "ship to" address, some argue that the only geographic certainty involves the seller's location. While this is correct, a seller could circumvent a tax scheme based on his location by placing his server in tax-free New Hampshire, for example, and claim that *is* his business location. In any event, in this report the Council does recommend that a new system for taxing interstate sales *not* provide a change in the current system for taxing the sale of intangibles and services.

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A bottom-line argument made by commentators for using the "destination" state is that the sales tax is a "consumption tax", and therefore the tax should be levied where the buyer takes possession.

The Council believes that the destination-based approach is likely the better one, after considering a number of factors, such as:

The destination-based approach is least disruptive to state tax law consensus: To the extent that interstate sales are currently subjected to sales taxes because a company happens to have a tax nexus in both the "exporting" and "importing" states, taxes are already collected on behalf of, and remitted to, the "importing" state. In other words, the destination-based approach is the one currently used when interstate sales are being taxed.

The destination-based approach provides local control: Under the destination-based approach, the consumer/taxpayer is also a voter in elections that determine who sets tax rates – and therefore there is local control over those rates. The moderating effect on tax rates when taxpayers are also voters can be discerned when general sales tax rates are compared to car rental and hotel taxes: Car and hotel taxes are higher – often levied as an add-on to the general sales tax.

Nevertheless, the Council does see benefits in an origin-based system and urges tax policymakers to study the matter further.

<sup>22</sup> See the discussion about distinguishing between tangible and intangible goods for tax purposes, note 19, above.

<sup>23</sup> "In addition, if information is accessed through the Internet, often the seller of the information-based service, whose services are purchased through credit card sales or through other financial intermediary ('cybercash'), will have no knowledge of the location of the buyer's physical location where the information is received. The financial intermediary may have the customer's billing address (not necessarily the same location as where the information is physically downloaded), but without a reporting requirement, that information would not normally be accessible either to the state auditor or to the seller. Because financial intermediaries are located throughout the world, the states cannot practically compel disclosure of that information through reporting requirements, quite apart from concerns regarding security of the buyer's financial information and privacy from its Internet information sellers." California Income and Franchise Tax Issues for Electronic Commerce, by Michael E. Brownell, an attorney with the California Franchise Tax Board. Presented at the Symposium on Multijurisdictional Taxation of Electronic Commerce, sponsored by the International Tax Program and The Society for Law and Tax Policy, Harvard Law School, held in Cambridge, MA, held on April 5, 1997. It was also reprinted in State Tax Notes Magazine, May 5, 1997 (12 State Tax Notes 1397) <http://www.e-commerce.ca.gov/backgroundmaterials/Brownell-StateTaxIssues.html>

<sup>24</sup> Today, merchants generally do collect address information, even when delivering products electronically, in an effort to prevent credit card fraud. Developments in security technology, from smart cards to digital certificates, may soon replace this method. Additionally, the design of electronic cash inherently allows anonymity.

Merchants must also collect ship-to information for current tax-law purposes: In those states that impose a sales tax, products sent out of state are tax-exempt. However, the seller must have proof that the product was, in fact, shipped out of state. Unless the buyer provides a physical address when arranging for the electronic delivery of a product, the seller will have no such proof. A state that enforces its domestic sales tax rules against every sale of intangibles for which there is no such proof may well chase sellers of intangibles out of state – or, at least, the servers from which the products are electronically shipped.

<sup>25</sup> From the tax booklet, "Resident, Forms & Instructions, 1997 Personal Income Tax Booklet" (Page 44):

"Additional Information

"California Sales And Use Tax

"If you purchased goods from an out-of-state retailer (such as a mail-order firm) and sales tax would have been charged if you had purchased the goods in California, you owe use tax on your purchase if the out-of-state retailer did not collect the tax.

"Your tax liability may be calculated by multiplying the sales tax rate in your area times the cost of the goods purchased. You may pay your tax liability by sending payment to the STATE BOARD OF EQUALIZATION, PO BOX 942879, SACRAMENTO CA 94279-0001, with a brief letter listing your name, address, a description and cost of the goods purchased, and the name and address of the out-of-state retailer...

"If you have a question concerning which goods are taxable, or want information about obtaining a seller's permit, please contact the State Board of Equalization's toll free number at 1-800-400-7115, to talk to a Customer Service Representative. Representatives are available from 8:00 a.m. to 5:00 p.m., Monday - Friday, excluding state holidays."

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<sup>26</sup> There is a concept in tax law termed "throw back". This concept is designed to deal with transactions involving an entity outside of the seller's state (or country) when the transaction is generally not assignable/taxable in the seller's state, but because the transaction is not assignable/taxable elsewhere it is "thrown-back" to the seller's state where it is taxed. (Throw-back is generally an issue in determining a company's income tax liability.) For the reasons stated in the main text, it is difficult to easily and accurately discern the buyer's state when intangible goods are sold. Therefore, an argument could be made that a new national policy for Internet sales should include an agreement that intangibles (and services) may be taxed in the *seller's* state. However, because the location *from* which intangibles (but not services) are sold and electronically sent to buyers can be anywhere – and can be changed rather quickly – any solution designed to tax such sales *somewhere* will be difficult to achieve. As for the sale of services, there are established tax concepts supporting their taxation where they are performed, not where they are consumed; thus, the seller's state would have a reasonable basis for taxing the sale of services.

Yet, in a growing number of instances, it will not be uncommon for a service to be performed in multiple locations – even when it is being performed for a single project. For example, consider a French company that owns a company in Florida, and the Florida company has subsidiaries in New York and California. The French parent decides to partially spin-off the Florida company, and it retains a San Francisco investment company to handle the transaction. That firm may involve affiliated offices in Paris and New York, as well as law and accounting firms in Miami. While the same established rules and concepts that are used to apportion income in a case such as this for *income tax* purposes could be used for *sales tax* purposes, the Supreme Court's ruling in *Oklahoma Tax Commission v. Jefferson Lines*, 514 US 175 (1995), suggests that apportionment is inappropriate for consumption tax purposes:

"A sale of goods [in this instance, a ticket for interstate bus transportation] is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed. We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future." 514 U.S. at 186.

Of course, even if the legal services performed are not subjected to apportionment, it could still be difficult to ascertain the single jurisdiction in which they would be subject to sales tax.

To understand "throw back", the following excerpt may be helpful from "California Income and Franchise Tax Issues for Electronic Commerce," note 23, above (Citations omitted):

"California, like most states, taxes corporations on or measured by their income from sources within the state. A taxpayer's business income is sourced to California based on an apportionment of its total business income, by application of UDITPA. As currently constituted, for most taxpayers, the California apportionment formula consists of the sum of a payroll factor, a property factor, and a double-weighted sales factor, with that sum divided by four. Most of the apportionment issues that affect taxpayers involved in electronic commerce lie in the sales factor and the property factor.

"The sales factor is the ratio of California sales to sales everywhere. The rules for determining whether a sale is a California sale depends on whether or not the item sold is tangible personal property. Sales of tangible personal property are assigned to the state of destination if the property is delivered or shipped to a purchaser in the state. If the taxpayer is not taxable in the destination state (i.e., is protected from taxation under Public Law 86-272 or constitutional nexus principles), the sale is 'thrown back' to the state from which the property is shipped. If the taxpayer is not taxable in either state, the sale is assigned to the state of the office of the salesman where the order was received.

"Under California law, if the sales of tangible personal property are made by a member of a unitary group and any member is taxable in the shipment destination state (even if the immediate seller is not taxable there), the sale is assigned to the destination state."

<sup>27</sup> This proposal appears to be at variance with the neutrality and base-broadening principles we have promoted, because it would exempt certain types of goods – e.g., shrink-wrapped software – from sales taxes. The struggle here is that, in order to meet these principles, California would have to start levying taxes on e-delivered software *and* actually collect it without suffering substantial "leakage" (i.e., sales that escape taxation due to their being undetected). As we have indicated, *effectively* taxing e-delivered products is not practical. Therefore, a line dividing the effectively taxable from the tax exempt must be drawn either (a) between e-delivered software and shrink-wrapped software or (b) between software and products other than software. We think that the better approach is (b).

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<sup>28</sup> While oversimplified, this example will illustrate the point: If current retail sales within a state are \$1 billion, and the tax rate is 5%, sales tax receipts would be \$50 million. If the ability to tax interstate sales increased the tax base to \$1.25 billion, then the tax rate could be lowered to 4% in order to yield the same \$50 million in revenues.